

Internal Revenue Service, Treasury

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third of such stock includible in the estate is redeemed for \$150,000.

(ii) The first distribution of \$150,000 is applied against the \$225,000 amount that qualifies for treatment under section 303, regardless of whether the first distribution was treated as in payment in exchange for stock under section 302(a). Thus, only \$75,000 of the second distribution may be treated as in full payment in exchange for stock under section 303. The tax treatment of the remaining \$75,000 would be determined under other provisions of the Code.

(h) For the purpose of section 303, the estate tax or any other estate, inheritance, legacy, or succession tax shall be ascertained after the allowance of any credit, relief, discount, refund, remission or reduction of tax.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6724, 29 FR 5343, Apr. 21, 1964; T.D. 7346, 40 FR 10669, Mar. 7, 1975]

§ 1.303-3 Application of other sections.

(a) The sole effect of section 303 is to exempt from tax as a dividend a distribution to which such section is applicable when made in redemption of stock includible in a decedent's gross estate. Such section does not, however, in any other manner affect the principles set forth in sections 302 and 306. Thus, if stock of a corporation is owned equally by A, B, and the C Estate, and the corporation redeems one-half of the stock of each shareholder, the determination of whether the distributions to A and B are essentially equivalent to dividends shall be made without regard to the effect which section 303 may have upon the taxability of the distribution to the C Estate.

(b) See section 304 relative to redemption of stock through the use of related corporations.

§ 1.304-1 General.

(a) Except as provided in paragraph (b) of this section, section 304 is applicable where a shareholder sells stock of one corporation to a related corporation as defined in section 304. Sales to which section 304 is applicable shall be treated as redemptions subject to sections 302 and 303.

(b) In the case of—

(1) Any acquisition of stock described in section 304 which occurred before June 22, 1954, and

(2) Any acquisition of stock described in section 304 which occurred on or after June 22, 1954, and on or before December 31, 1958, pursuant to a contract entered into before June 22, 1954.

The extent to which the property received in return for such acquisition shall be treated as a dividend shall be determined as if the Internal Revenue Code of 1939 continued to apply in respect of such acquisition and as if the Internal Revenue Code of 1954 had not been enacted. See section 391. In cases to which this paragraph applies, the basis of the stock received by the acquiring corporation shall be determined as if the Internal Revenue Code of 1939 continued to apply in respect of such acquisition and as if the Internal Revenue Code of 1954 had not been enacted.

[T.D. 6533, 26 FR 401, Jan. 19, 1961]

§ 1.304-2 Acquisition by related corporation (other than subsidiary).

(a) If a corporation, in return for property, acquires stock of another corporation from one or more persons, and the person or persons from whom the stock was acquired were in control of both such corporations before the acquisition, then such property shall be treated as received in redemption of stock of the acquiring corporation. The stock received by the acquiring corporation shall be treated as a contribution to the capital of such corporation. See section 362(a) for determination of the basis of such stock. The transferor's basis for his stock in the acquiring corporation shall be increased by the basis of the stock surrendered by him. (But see below in this paragraph for subsequent reductions of basis in certain cases.) As to each person transferring stock, the amount received shall be treated as a distribution of property under section 302(d), unless as to such person such amount is to be treated as received in exchange for the stock under the terms of section 302(a) or section 303. In applying section 302(b), reference shall be had to the shareholder's ownership of stock in the issuing corporation and not to his ownership of stock in the acquiring corporation (except for purposes of applying section 318(a)). In determining control and applying section 302(b), section

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318(a) (relating to the constructive ownership of stock) shall be applied without regard to the 50-percent limitation contained in section 318(a)(2)(C) and (3)(C). A series of redemptions referred to in section 302(b)(2)(D) shall include acquisitions by either of the corporations of stock of the other and stock redemptions by both corporations. If section 302(d) applies to the surrender of stock by a shareholder, his basis for his stock in the acquiring corporation after the transaction (increased as stated above in this paragraph) shall not be decreased except as provided in section 301. If section 302(d) does not apply, the property received shall be treated as received in a distribution in payment in exchange for stock of the acquiring corporation under section 302(a), which stock has a basis equal to the amount by which the shareholder's basis for his stock in the acquiring corporation was increased on account of the contribution to capital as provided for above in this paragraph. Accordingly, such amount shall be applied in reduction of the shareholder's basis for his stock in the acquiring corporation. Thus, the basis of each share of the shareholder's stock in the acquiring corporation will be the same as the basis of such share before the entire transaction. The holding period of the stock which is considered to have been redeemed shall be the same as the holding period of the stock actually surrendered.

(b) In any case in which two or more persons, in the aggregate, control two corporations, section 304(a)(1) will apply to sales by such persons of stock in either corporation to the other (whether or not made simultaneously) provided the sales by each of such persons are related to each other. The determination of whether the sales are related to each other shall be dependent upon the facts and circumstances surrounding all of the sales. For this purpose, the fact that the sales may occur during a period of one or more years (such as in the case of a series of sales by persons who together control each of such corporations immediately prior to the first of such sales and immediately subsequent to the last of such sales) shall be disregarded, provided the other facts and cir-

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cumstances indicate related transactions.

(c) The application of section 304(a)(1) may be illustrated by the following examples:

Example (1). Corporation X and corporation Y each have outstanding 200 shares of common stock. One-half of the stock of each corporation is owned by an individual, A, and one-half by another individual, B, who is unrelated to A. On or after August 31, 1964, A sells 30 shares of corporation X stock to corporation Y for \$50,000, such stock having an adjusted basis of \$10,000 to A. After the sale, A is considered as owning corporation X stock as follows: (i) 70 shares directly, and (ii) 15 shares constructively, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 30 shares owned directly by Y. Since A's percentage of ownership of X's voting stock after the sale (85 out of 200 shares, or 42.5%) is not less than 80 percent of his percentage of ownership of X's voting stock before the sale (100 out of 200 shares, or 50%), the transfer is not "substantially disproportionate" as to him as provided in section 302(b)(2). Under these facts, and assuming that section 302(b)(1) is not applicable, the entire \$50,000 is treated as a dividend to A to the extent of the earnings and profits of corporation Y. The basis of the corporation X stock to corporation Y is \$10,000, its adjusted basis to A. The amount of \$10,000 is added to the basis of the stock of corporation Y in the hands of A.

Example (2). The facts are the same as in *Example (1)* except that A sells 80 shares of corporation X stock to corporation Y, and the sale occurs before August 31, 1964. After the sale, A is considered as owning corporation X stock as follows: (i) 20 shares directly, and (ii) 90 shares indirectly, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 80 shares owned directly by Y and 50 percent of the 100 shares attributed to Y because they are owned by Y's stockholder, B. Since after the sale A owns a total of more than 50 percent of the voting power of all of the outstanding stock of X (110 out of 200 shares, or 55%), the transfer is not "substantially disproportionate" as to him as provided in section 302(b)(2).

Example (3). Corporation X and corporation Y each have outstanding 100 shares of common stock. A, an individual, owns one-half the stock of corporation X, and C owns one-half the stock of corporation Y. A, B, and C are unrelated. A sells 30 shares of the stock of corporation X to corporation Y for \$50,000, such stock having an adjusted basis of \$10,000 to him. After the sale, A is considered as owning 35 shares of the stock of corporation X (20 shares directly and 15 constructively because one-half of the 30 shares owned by corporation Y are attributed to him). Since

before the sale he owned 50 percent of the stock of corporation X and after the sale he owned directly and constructively only 35 percent of such stock, the redemption is substantially disproportionate as to him pursuant to the provisions of section 302(b)(2). He, therefore, realizes a gain of \$40,000 (\$50,000 minus \$10,000). If the stock surrendered is a capital asset, such gain is long-term or short-term capital gain depending on the period of time that such stock was held. The basis to A for the stock of corporation Y is not changed as a result of the entire transaction. The basis to corporation Y for the stock of corporation X is \$50,000, i.e., the basis of the transferor (\$10,000), increased in the amount of gain recognized to the transferor (\$40,000) on the transfer.

Example (4). Corporation X and corporation Y each have outstanding 100 shares of common stock. H, an individual, W, his wife, S, his son, and G, his grandson, each own 25 shares of stock of each corporation. H sells all of his 25 shares of stock of corporation X to corporation Y. Since both before and after the transaction H owned directly and constructively 100 percent of the stock of corporation X, and assuming that section 302(b)(1) is not applicable, the amount received by him for his stock of corporation X is treated as a dividend to him to the extent of the earnings and profits of corporation Y.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11997, Aug. 23, 1968]

§ 1.304-3 Acquisition by a subsidiary.

(a) If a subsidiary acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock shall be treated as though the parent corporation had redeemed its own stock. For the purpose of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304(c). The determination whether the amount received shall be treated as an amount received in payment in exchange for the stock shall be made by applying section 303, or by applying section 302(b) with reference to the stock of the issuing parent corporation. If such distribution would have been treated as a distribution of property (pursuant to section 302(d)) under section 301, the entire amount of the selling price of the stock shall be treated as a dividend to the seller to the extent of the earnings and profits of the parent corporation determined as if the distribution had been made to it of the property that the subsidiary exchanged

for the stock. In such cases, the transferor's basis for his remaining stock in the parent corporation will be determined by including the amount of the basis of the stock of the parent corporation sold to the subsidiary.

(b) Section 304(a)(2) may be illustrated by the following example:

Example. Corporation M has outstanding 100 shares of common stock which are owned as follows: B, 75 shares, C, son of B, 20 shares, and D, daughter of B, 5 shares. Corporation M owns the stock of Corporation X. B sells his 75 shares of Corporation M stock to Corporation X. Under section 302(b)(3) this is a termination of B's entire interest in Corporation M and the full amount received from the sale of his stock will be treated as payment in exchange for this stock, provided he fulfills the requirements of section 302(c)(2) (relating to an acquisition of an interest in the corporations).

§ 1.304-4T Special rule for use of a related corporation to acquire for property the stock of another commonly owned corporation (temporary).

(a) *In general.* At the discretion of the District Director, for purposes of determining the amount constituting a dividend, and source thereof, under section 304(b)(2), a corporation (deemed acquiring corporation) will be considered to have acquired for property the stock of a corporation (issuing corporation) acquired for property by another corporation (acquiring corporation) that is controlled by the deemed acquiring corporation, if one of the principal purposes for creating, organizing, or funding the acquiring corporation, through capital contributions or debt, is to avoid the application of section 304 to the deemed acquiring corporation. The following example illustrates the application of this paragraph (a).

Example. P, a domestic corporation, owns all of the stock of CFC1, a controlled foreign corporation with substantial accumulated earnings and profits. CFC1 is organized in Country X, which imposes a high rate of tax on CFC1's income. P also owns all of the stock of CFC2, another controlled foreign corporation, which has accumulated earnings and profits of \$200x. CFC2 is organized in Country Y which imposes a low rate of tax on CFC2's income. P wishes to own all of its foreign corporations in a direct chain and to effectuate a repatriation of CFC2's cash to P. In order to avoid having to obtain Country X